



THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

May 9, 2001

The Honorable John D. Dingell  
Ranking Member  
Committee on Energy and Commerce  
U.S. House of Representatives  
2322 Rayburn House Office Building  
Washington, D.C. 20515-6115

Dear Congressman Dingell:

In your letter dated March 13, 2001, you asked for a follow-up report on the progress of the National Association of Securities Dealers, Inc. ("NASD") in implementing certain undertakings the Commission had ordered as part of its settlement of an enforcement action against the NASD for failure to enforce adequately its own rules. Your recent letter identified five items in our December 1999 report as outstanding matters or continuing deficiencies. The attached memorandum, prepared by SEC staff, provides an update regarding each of these items.

Overall, I believe the remedial actions undertaken by the NASD have enhanced the Nasdaq Stock Market to the benefit of investors. The NASD has committed substantial resources to fulfill the fourteen undertakings required by the Commission in its 1996 enforcement action. As more fully described in the staff memorandum, progress has been made in each of the five areas identified in your letter. Although I have been satisfied with the NASD's progress to date, my staff continues to monitor its efforts.

Thank you for your interest in the NASD's efforts. If you have questions or comments, please do not hesitate to contact me or Annette L. Nazareth, Director of the SEC's Division of Market Regulation, at (202) 942-0090.

Sincerely,

A handwritten signature in cursive script, reading "Laura S. Unger".

Laura S. Unger  
Acting Chairman

Enclosure

The Honorable John D. Dingell  
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cc: The Honorable W.J. "Billy" Tauzin, Chairman  
Committee on Energy and Commerce

The Honorable Michael G. Oxley, Chairman  
Committee on Financial Services

The Honorable John J. LaFalce, Ranking Member  
Committee on Financial Services

## MEMORANDUM

TO: Laura S. Unger, Acting Chairman

FROM: Robert L.D. Colby, Deputy Director *BC*  
Division of Market Regulation

DATE: May 8, 2001

SUBJECT: Update: Status and Effectiveness of NASD Actions since the § 21(a) Report

This memorandum responds to Congressman Dingell's request to update the Commission's comprehensive report, dated December 17, 1999 ("1999 Report"), on the National Association of Securities Dealers, Inc.'s ("NASD") progress in fulfilling the fourteen undertakings required by the Commission in its 1996 order ("SEC Order"). This memorandum provides information about the five items raised in Congressman Dingell's March 13, 2001 letter that our 1999 Report enumerated as outstanding matters or continuing deficiencies.<sup>1</sup>

**1. Status of a restricted list and systems changes for monitoring applicable short sale and holding-period restrictions.**

Update. Prohibited List. During the fourth quarter of 1999, the NASD replaced an interim prohibited list with a comprehensive prohibited list that is posted on the NASD's corporate intranet and consists of broker/dealer stocks and the stocks of companies that derive more than 25 percent of their annual gross revenues from broker/dealer subsidiaries. The NASD also posts on its corporate intranet a watch list, consisting of companies that appeared to be approaching the 25 percent threshold. The NASD Office of General Counsel ("OGC") advises us that the NASD conducts an annual review of companies that have crossed (or are approaching) the 25 percent threshold based on the availability of audited annual financial statements and year-end FOCUS information. The next update to the prohibited list and watch list will be (on the basis of 2000 year-end financial information) in May 2001. Other updates to these lists (e.g., adding newly public broker/dealers, symbol changes, delistings, mergers) are performed throughout the year. OGC advises that the NASD has performed quarterly automated comparisons of stocks on the prohibited list to employees' transactions since June 1999, and any violations discovered are reported to management for disciplinary action.

90-Day Holding Period and Net Short Prohibitions. OGC advises that system changes necessary to monitor compliance with the 90-day holding period and net short positions were delayed until the fourth quarter of 2000 due to technical problems related to the integration of

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<sup>1</sup> In responding to Congressman Dingell's inquiry, we have relied, in part, upon the representations of NASD staff and the NASD Regulation ("NASDR") staff. To monitor the NASD's ongoing compliance with the required undertakings, our Office of Compliance Inspections and Examinations ("OCIE") also is currently conducting an inspection of the NASDR's disciplinary program, its TMMS examination program, and the impact of OATS on its automated surveillance efforts.

the American Stock Exchange ("Amex") employees under the NASD Code of Conduct. OGC now reports that this system became operational during the first quarter of 2001 and that exception reports will be distributed to managers each quarter. Initial exception reports were distributed to department heads in mid-April 2001, following completion of data entry for the fourth quarter of 2000. Because the exception reports have only recently been generated, the Commission does not have sufficient experience to assess whether this system is sufficiently monitoring compliance with the 90-day holding period and net short prohibitions.

## **2. Status of independent internal audit staff and its review of all aspects of NASD operations, including regulatory and disciplinary processes.**

Update. OGC reports that the NASD's Internal Review Department successfully completed the 1999 and 2000 Audit Plans that were approved by the NASD Audit Committee and has also been able to fulfill the NASD's commitments in the form of an annual audit plan to the Audit Committee.<sup>2</sup> The 1999 Report indicated that high staff turnover among the Internal Review Department staff hampered the Audit Committee in carrying out its responsibilities. The Internal Review Department's turnover rate has declined to approximately 18% per year. The turnover rate among the business area audit staff was 10% through March 2001. Turnover among the information technology (IT) audit staff has been higher, which the OGC states is typical in light of the market for IT auditors, in general. Two-thirds of the turnover among the IT audit staff has been intra-organizational moves into other areas within the NASD organization. The NASD states that it is addressing this problem through contracting with a consulting firm that provides temporary staffing for internal auditing.

## **3. Status of implementation of OATS (NASD's Order Audit Trail System).**

Update. OATS data is currently combined with trades, market participant quotes, and inside quotes in time sequence to create an integrated audit trail (called the "Enhanced Audit Trail" or "EAT") that allows NASDR staff to recreate events in the marketplace during the course of an investigation. Other than automated surveillance designed to detect OATS reporting violations, the only automated surveillance program that is fully operational is the Advanced Detection System ("ADS"), which allows NASDR to review limit orders received by member firms and reported to OATS for compliance with one aspect of the SEC's limit order display rule (SEC Rule 11Acl-4). NASDR reports that it is currently developing additional automated surveillance programs that will use OATS data to review for timeliness of execution of market orders, limit order protection, spoofing, and frontrunning of agency orders. Some of these programs are in the early stages of development.

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<sup>2</sup> OGC states that these Audit Plans included analysis and risk assessment of all aspects of the NASD, including the regulatory and disciplinary processes, the market and exchange activities of The Nasdaq Stock Market and the Amex, and the automated systems that support each of these functions. OGC states that the Internal Review Department has also established an Audit Plan for 2001 that provides coverage of a broad range of risk factors within the organization and is making progress toward completing this plan.

The final phase of OATS implementation (the inclusion of manual orders) has been postponed. The NASD filed a proposal with the SEC in April 2000. Implementation of this phase will begin following SEC approval of the current rule filing; the Commission is currently awaiting a written response from NASDR to the 12 comment letters.

NASDR has six full-time positions dedicated to OATS enforcement efforts and, since 1999, has completed or initiated 91 formal or informal disciplinary actions. To address data integrity problems, the NASDR has developed or is developing eight new surveillance sweeps to monitor compliance with the OATS rules to ensure that members are submitting all data to create a more complete audit trail. These sweeps will concentrate on missing and late data submissions, failure to repair rejected reports, failure to submit specific required reports, the inability to match orders to trades, as well as orders between firms, and failure to report OATS events in a time-sequenced manner.

NASDR also states that it has undertaken and plans to undertake several steps that are designed to assist NASD members in complying with OATS requirements. First, beginning in the fall of 1999, NASDR began providing OATS reporting statistics, along with the underlying detail data, to member firms via the OATS Website to enable firms to identify and correct potential problems. Second, upon approval of its proposed OATS rule changes and the launch of Phase III, NASDR staff will conduct OATS conference calls for member firms to provide information concerning OATS and respond to member questions regarding OATS. Third, NASDR has developed a member education plan in connection with the implementation of Phase III of OATS.

Although there have been many improvements to the OATS program, the overall data integrity in OATS is still inadequate; therefore, the NASDR's enforcement efforts and member education efforts described above are critical. Without accurate and complete OATS information, there are gaps in the integrated audit trail. We will continue to monitor the NASDR's efforts to address this problem.

#### **4. NASD surveillance and examination of order handling: status of Trading and Market Maker Surveillance (TMMS) examination unit.**

Update. The TMMS program is responsible for conducting annual examinations of all "Tier 1" firms. "Tier 1" firms include those market making firms that report, in the aggregate, 90% of Nasdaq National Market, Nasdaq SmallCap, Third Market, and Over-The-Counter Bulletin Board securities, and all electronic communications networks. In 2001, this represents approximately 76 firms. For the 2000 examination cycle, NASDR reports that the TMMS staff met its goals for timeliness of initiation of examinations and interim goals for completion of examinations. The NASDR does not anticipate having any problems completing all the 2000 examinations by its May 2001 deadline. The NASDR reports that the 2001 examination cycle is on schedule.

In 2000, the TMMS program suffered a turnover rate of 36%. This turnover included three supervisory positions. However, this year to date, the turnover rate has only been 6.7%. In

2001, NASDR included the TMMS staff in an employee retention program that is designed to retain NASDR employees in highly marketable areas. NASDR states that it will continue to monitor staff retention rates and again take proactive and appropriate measures when needed.<sup>3</sup>

As stated above, OCIE is currently conducting an inspection of the TMMS examination program. Although OCIE believes that the program has improved substantially since its introduction in 1995, any deficiencies will be addressed in the final inspection report.

## **5. Status of NASD's trade reporting surveillance procedures.**

Update. NASDR continues to use three regulatory programs to regulate member compliance with applicable trade reporting rules: (1) trade reporting sweeps; (2) trade reporting alerts through the use of ADS; and (3) TMMS examinations. Trade reporting "sweeps" were instituted in January 1999 as a means to focus on overall compliance with the trade reporting rules. Sweeps are conducted quarterly using automated surveillance programs that examine relevant activity by all firms in relevant time periods. Currently, there are eight trade reporting sweeps in operation that examine for, among other things, high instances of late trade reporting and the misuse of trade reporting modifiers. The TMMS staff selects firms for review that exhibit a strong pattern of non-compliance. Since inception of the sweep process, NASDR has brought over 160 formal or informal disciplinary actions.

The trading reporting feature of ADS generates alerts if a firm's activity matches a pre-programmed pattern of violative conduct. Since 1999, the staff has reviewed 7,783 trade-reporting alerts generated by ADS. In addition to other ongoing investigations, NASDR has brought three disciplinary actions since the 1998 Report.

As discussed above, NASDR also conducts TMMS examinations to surveil for trade reporting compliance. While periodic trade reporting sweeps now cover many of the trade reporting areas previously covered by TMMS examinations, TMMS examinations are still used to examine for compliance with new trade reporting requirements, such as riskless principal trade reporting.<sup>4</sup>

OCIE's most recent inspection of the NASDR's trade reporting surveillance procedures was finalized in April 1999. This inspection was conducted prior to the availability of OATS data for use in trade reporting surveillance. The next inspection of NASDR's trade reporting surveillance program is scheduled for fiscal year 2002. Accordingly, the Staff will make a comprehensive assessment of the adequacy of the program, including its use of OATS data, at that time.

<sup>3</sup> The TMMS program now includes five supervisors instead of three. Senior management now includes an Associate Director, a Director, and a Vice President to oversee the program.

<sup>4</sup> TMMS examiners conducting non-trade-reporting reviews also have been trained to identify trade-reporting problems that may become apparent during these reviews.